Commonwealth Corner – Investor Updates

The Franchise Disclosure Document – What does it tell you?

An investment in a franchise usually involves parting with thousands of hard-earned dollars and entering into a long-term relationship with a company seeking to expand its brand and widen the distribution of its product or service. In return, you expect to own and operate a business using an established name and business system, with support, training and other assistance from the franchisor. In today's difficult economy, it is more important than ever to thoughtfully study and research the franchise opportunity before investing. <u>Carefully reading and understanding the Franchise Disclosure Document (FDD) is one of the most crucial steps to take before signing any franchise agreement or paying any money</u>.

A franchisor must give its FDD to prospective franchisees at least 14 days before an agreement is signed or money is exchanged. The FDD will include disclosure about what's expected of you as a franchisee and what you should expect from the franchisor. The FDD discusses the experience of company executives, financing, fees to be paid, litigation, the network of franchisees, the terms of the franchise agreement and much more.

Careful study of the FDD can increase the likelihood that you experience success as a franchise owner. Below are some highlights of what you can find in the FDD.

Franchisor background and experience

In the FDD, you'll find key information about the history of the franchisor's past activities – including how long it has operated the type of business offered. Consider how long it has been in business and whether its business model has been tested over time.

Litigation disclosure

The FDD contains useful information about the franchisor's litigation history over the past 10 years – including a new requirement for the franchisor to disclose the number of suits it filed against its franchisees in the past year.

Numerous lawsuits against the franchisor reveal that some franchisees are dissatisfied enough to undergo the significant costs of litigation.

Any felony or fraud convictions of the franchisor's top executive officers must also be disclosed in the FDD.

Franchise Fees, Start-up costs, Royalties

These expenses vary from franchisor to franchisor. The FDD provides a standardized way for you to compare the initial investment and ongoing fees required from one franchise to another.

Product sourcing restrictions

The FDD will identify the restrictions you must operate under when purchasing inventory, supplies and other goods.

Many systems mandate that these products be purchased from the franchisor, or from suppliers designated by the franchisor, leaving franchisees with limited ability to purchase similar goods from other suppliers (at potentially lower costs). The FDD should describe these restrictions and tell you if top management of the franchisor has a financial interest in the designated suppliers.

When you purchase supplies or equipment from the franchisor's approved sources, be aware that the franchisor may receive kickbacks or other revenues from the selected vendors. If this is the case, the FDD should tell you the percentage of its revenue that is derived from designated or approved suppliers.

Training

Training by the franchisor is a major reason many people considering buying a franchise, and the quality of the franchisor's training program is an important tool in the successful operation of the franchise. The FDD tells you important details about the franchisor's training program, including a very significant one: whether the instructors have actual, practical experience operating the franchise or similar business. The scope and duration of the training is also presented in the FDD in a tabular format, for easy comparison to other franchise systems. It will also tell you what costs you will be responsible for while attending the training program.

Protected Area or Territory

Even though you may receive a protected territory in which the franchisor has agreed not to open another unit, you may still compete with the franchisor for sales if the franchisor reserves the right to use less traditional ways to market its product or service, such as through the internet, direct marketing or telemarketing. You may be restricted to operating only in a particular territory or you may be required to reach monthly or annual sales quotas to retain your territory protection. Also, your choices for the site of your business are often subject to the franchisor's approval and criteria. The FDD can help you better understand these provisions and restrictions.

Trademark Protection

One of the obvious benefits buying a franchise is receiving the right to use the franchisor's recognized name and mark in the operation of your business. This is an important part of what you are paying for, and you should consider if the franchisor has taken the steps necessary to protect this and other key intellectual property. The FDD will tell you if the trademark is federally registered and whether the franchisor will assist you in defending your right to use the name should it be challenged. The FDD should also tell you if the franchisor is aware of any existing infringing use of the name by other persons that may affect your use of the trademark.

Contract renewal, transfer and termination

Not every franchise system will renew or extend your franchise when the initial term expires. Those that do may require you to sign a new franchise agreement with different terms and provisions than you are accustomed to. You may be required to pay higher monthly royalties or make significant improvements during the successor term.

If you wish to sell or transfer your franchise during its term, the prior written approval from the franchisor is usually necessary, and the franchisor may deny the sale if the buyer you have found is not acceptable to the franchisor.

Although termination of a franchise without good cause is prohibited by the Virginia Retail Franchising Act, conditions under which the franchise may be terminated are usually more favorable to the franchisor. The franchisor may also give itself generous opportunities to cure defaults, without extending the same benefits to its franchisees.

At the end of the franchise relationship, if your contract contains a "noncompete" clause, you may be unable to operate a similar business for a designated period of time or within a certain geographic region.

Performance Representations

Some franchisors will provide you with information about the levels of earnings or profits you can expect to make as a franchisee. In most every case, the franchisor must include this data in its FDD, and the FDD requires the franchisor to have a reasonable, factual basis for this information. You should be especially wary of any information you receive about potential earnings that is not contained in the FDD.

Existing and Former Franchisees

Names and contact information of current and former franchisees are also included in the FDD. This will help you interview others who have already purchased the franchise to ask about the franchisor's responsiveness to problems and the level of support provided. This is a valuable way for you to confirm information you have be given by the franchisor and find out if the franchisor consistently has the best interests of its franchisees in mind.

Also, if you are interested in a particular existing unit, the FDD helps protect against "churning" (attempts to repeatedly sell an unsuccessful location) by requiring the franchisor to provide the history of that unit, including the contact information of previous owners and the reason for the change of ownership.

Financial Statements

A franchisor is required to include its audited financial statements in the FDD. Reviewing these financial statements can help you assess the financial condition of the franchisor and its ability to support the franchise system on a going forward basis. Be aware that a franchisor in financial difficulty may not be able to fulfill its obligations to its franchisees.

Other Risks

The FDD can alert you to other risks such as:

A requirement that you agree to resolve disputes by arbitration, rather than going to court.

A requirement that any litigation or arbitration of a dispute must take place in the franchisor's home state, rather than in Virginia.

A "choice of law" clause in the franchise agreement – where the franchisor specifies which state law will be applied to resolve a dispute.

Remember, it is always an excellent idea to have the FDD, the franchise agreement, and the financial statements reviewed by a lawyer or accountant before you make an investment decision.

Also, the Virginia law requires the franchisor to register the franchise with Virginia Division of Securities and Retail Franchising before offering or selling the franchise in Virginia. Please contact us to ask or confirm whether the franchise is registered before you buy.

You may reach the Division by phone at (800) 552-7945 (toll free, in Virginia only), or (804) 371-9051.